

TRENDS AND ISSUES

DECEMBER 2008

PRODUCT AND DISTRIBUTION EVOLUTION IN THE LIFE INSURANCE INDUSTRY

Ben Baldwin, Jr.
President
Baldwin Financial Systems, LLC.

Thomas R. Holt
Vice President
TIAA-CREF Life Insurance Company
TIAA-CREF Individual & Institutional Services, LLC.

Paul J. Yakoboski
Principal Research Fellow
TIAA-CREF Institute

EXECUTIVE SUMMARY

The life industry is in the midst of fundamental and inevitable change. The traditional distribution model of commission-based sales is yielding to new models. Evidence is found in the decrease of life insurers operating in the U.S., industry demutualization, and the decreased number of affiliated agents combined with the emergence and growth of direct and independent advisor distribution channels. Such trends signal a fundamental restructuring of how life products are structured and delivered.

Basic, consumer-friendly life insurance providing pure income protection is becoming increasingly commoditized. Simultaneously, investment-related, no-commission life products providing wealth management capabilities are becoming increasingly sophisticated. Pure-protection products are consistent with a world where people “do it themselves” through direct channels such as the internet. Proper use of investment-related life insurance in the development and execution of holistic financial plans for wealthy families is typically beyond the current training and skill-set of traditional life insurance agents. Furthermore, a distribution model with commissions based strictly on sales followed by insignificant renewals does not fit investment-related life products that become more valuable and management-intensive over time.

Proper selection and management of investment-related life products can be profitably managed by individuals or groups with a fiduciary client relationship, such as fee-only registered investment advisors (RIAs). RIAs have the deep understanding of their clients that makes life insurance selection and management a natural part of a comprehensive, multigenerational financial planning and wealth management engagement. RIAs are typically not insurance-licensed. A fiduciary model where the advisor functions solely in the client's best interest is inconsistent with undisclosed compensation common to commission-distributed products. The market is responding with life products unencumbered with undisclosed commissions.

In this environment, service becomes a primary requirement for meeting the needs of both consumer types. For the buyers of investment-related life products, the life insurer must effectively service the RIA by providing the required product lineup accompanied by real-time information and product control, as well as all required in-house services and competency-compensated agent services.



FINANCIAL SERVICES
FOR THE GREATER GOOD®

INTRODUCTION

In 1942, Joseph Schumpeter used the term “creative destruction” in *Capitalism, Socialism and Democracy* to label the process of mutation that incessantly revolutionizes the economic structure from within, destroying the old one and creating a new one. Innovation creates obsolescence and replaces it. In 1976, James C.H. Anderson predicted that creative destruction would occur in the life insurance industry (Anderson 1976). Anderson made a number of arguments, including:

... it is no longer realistic to assume that the typical life insurance buyer is one who will, for an extended period of time, remain married to the same wife, work at the same job and live in the same house situated in the same city; or that the financial security needs of this typical buyer and his ability to pay for them will remain constant and can be expressed in constant nominal dollars.

... it is not realistic for the industry to address the needs of the typical buyer with traditional permanent life insurance products requiring fixed regular premiums and providing fixed benefits, both expressed in constant nominal dollars.

... the traditional life insurance distribution and administrative systems are excessively and unnecessarily costly and place the industry at a competitive disadvantage by comparison with other savings media.

... the industry should respond to the needs of the contemporary market by introducing a simplified, flexible and less costly product.

... the introduction of such a product is technically and financially feasible if a more effective distribution system can concurrently be developed.

... the introduction of such a product would probably have a serious and adverse initial impact on the life insurance industry and its existing distribution systems.

... notwithstanding the foreseen difficulties, the needs and demands of the market will lead to the introduction of such a product, possibly led by companies with no commitment to traditional systems, ...

So, why didn't the life insurance industry respond by introducing a simplified, flexible and less costly life insurance product some thirty-two years ago as called for by Anderson? And, why is it reasonable to think the industry will create the product now? The answer, which Anderson foresaw in his predictions above, is “who is in charge.”

In 1976, distribution drove the life industry. The common wisdom was that you could not sell it if you could not get shelf space. Agents would not give up their traditional high first-year commissions that were followed by generous renewals. Managers claimed that this commission structure was needed to get new agents started in the business. No company questioned the status quo and built an alternative distribution system in that environment.

Today the life insurance industry is experiencing a period of intense creative destruction.

- The number of life insurers doing business in U.S. has decreased from a peak of 2,343 in 1988 to 1,072 in 2006 (ACLI 2007).
- The industry continues to demutualize; the percentage of industry premium income and assets accounted for by stock companies increased from 74 percent to 79 percent and from 65 percent to 78 percent, respectively, between 1997 and 2006 (ACLI 1998 and 2007).

- The number of affiliated agents fell from 256,735 in 1973 to 160,917 in 2004, and is projected to continue falling to 122,000 in 2016 (LIMRA International 2007).
- The share of life insurance sales, as measured by percent of first-year premium, accounted for by affiliated agents has fallen from 62 percent in 1983 to 35 percent in 2005 (Retzloff et al. 2006).
- The percentage of households with a life insurance policy purchased through a face-to-face meeting with an agent, broker or other financial professional has fallen from 72 percent in 1960 to 41 percent in 2004. In addition, over 20 percent of U.S. households carry no life insurance whatsoever (Retzloff 2005).

Such trends do not signal the eventual extinction of the life industry. The basic income protection need for life insurance remains unchanged. The most common reason for purchasing life insurance is income replacement, cited by 66 percent of buyers (Terry 2005), but less than 80 percent of U.S. households have life insurance coverage and 40 percent of these believe they need additional coverage (Retzloff 2005). At the same time, however, the traditional life insurance distribution model of affiliated agent-based sales has been giving way over the past decade-plus to new channels.

Conventional wisdom maintains that current trends in the life industry are driven by pressure from stock holders for consistent profitability and growth in share prices. The argument continues that this pressure has resulted in cost-cutting measures harming the long-run ability of the industry to effectively function, largely due to decreased investments in distribution, and in particular, recruiting and retaining the traditional sales force (see Woods 2008, for example). Plus, this is occurring at a time when 40 percent of affiliated life agents plan on retiring in the next 10 years (Panko 2008). While there may be truth in the conventional wisdom, it ignores fundamental dynamics that also are at work in the industry.

The trends outlined above are in fact harbingers of a restructuring underway in the delivery of life products and the design of those products. Increased spending to expand the traditional distribution model is not a cure for an ailing industry. The industry is not ailing; rather, it appears to be evolving as the marketplace and consumer needs dictate. These are the signs of a healthy, dynamic industry. However, the traditional distribution model of high-commissioned agents whose compensation is based strictly on sales is becoming obsolete.

Today, the traditional distribution model is in disrepute as a result of excesses and imbalances that have been costly to the consumer. In addition, ready access to information through the internet and other sources has transferred power to the consumer. Innovation is defined as getting closer to the consumer, and removing the commissioned agent along with the layered support system of middle management from the distribution process achieves this objective. The “information age” has caused these positions to become expensive interveners. Innovative insurance companies are building distribution systems allowing the consumer to buy life insurance directly from the insurer. The traditional commission compensated agent is no longer the only way to distribute life insurance.

An increasing number of consumers deal with insurance company in-house salaried agents and seek ongoing service directly from the insurer. If something other than insurance company service is desired, such as is likely with investment-related life products, the consumer can hire a financial advisor of his or her choice to provide that service and policy asset management. The ability to do so becomes more important as the insured ages and the amount of the capital in the policy becomes greater.

The new order of life insurance distribution will be determined by the standard set by no-commission, no-surrender charge life insurance products that are driving the industry toward greater transparency. In addition, the emergence of “fiduciary-friendly” life insurance will extend the importance of professional advisors into the consumer’s life insurance purchase decision.

PRODUCT AND DELIVERY EVOLUTION

Life insurance product design is evolving along two distinct lines. Basic life insurance products providing pure-protection for families are becoming increasingly commoditized, i.e., plan features and available options are essentially the same across insurers. As this happens, market forces will drive price differentials across companies toward zero on such products for consumers with similar demographics regarding health, age, occupation and avocation (Bisker et al. 2005).

This dynamic will be reinforced by the increasing importance of direct channels of product distribution, such as call centers, direct mail, e-mail marketing, and the internet. Currently, over 10 percent of U.S. households own life insurance purchased through direct channels and over one-third of individuals who made a purchase after shopping for life insurance bought through a direct means. In addition, over one-half of direct buyers own only term insurance (Retzloff et al. 2006). While growth in on-line purchases may continue to lag other channels, information gathering (product and company information, price comparisons, and needs calculations) via the internet is becoming more important. Thirty-seven percent of middle market insurance buyers used the internet for information gathering purposes during their most recent purchase (Art 2007b). At the same time, approximately 20 percent of Generation Y and younger members of Generation X would like to purchase life insurance online, as well as 17 percent of the older members of Generation X (Art and Ahmed 2008). Twenty-three percent of online consumers who may buy term life insurance in the future say they are most likely to do so online (Art 2007a).

WEALTH MANAGEMENT PRODUCTS

At the same time, investment-related life products providing wealth management capabilities are becoming increasingly sophisticated. Seventy-one percent of life insurance buyers with investable assets of \$2 million or more discovered their insurance need while building a financial plan; the most commonly cited objectives for the purchase are wealth transfer, managing inheritances and paying estate taxes (Terry 2008). Proper use of these life products in the development and execution of a holistic financial plan for wealthy families is as much an art as a science.

At some point in their lives, wealthy families graduate from needing life insurance in order to provide for typical family needs in case of death to wanting life insurance to fulfill legacy issues. For example, if their death would create any tax liability, as would be discussed in an estate planning engagement with their financial and legal advisors, they may wish to provide cash via life insurance to pay these costs rather than have legacy assets hurriedly sold to pay these expenses. Also, there is an increasing realization on the part of the wealthy that storing their liquid legacy assets inside of a life insurance policy can provide state-specific asset protection, multiple tax benefits and risk management advantages for those assets.

Proper selection and long-term management of investment-related life products for high net worth clients will be increasingly provided by entities such as fee-only registered investment advisors (RIAs) that are typically not insurance licensed. A RIA manages the assets and risk management needs of high net-worth individuals, as well as institutional investors.

Traditional agents typically are not trained, nor compensated, nor operationally organized to provide such ongoing services. Furthermore, a distribution model of relatively high initial commissions, sometimes undisclosed, based on the initial sales process followed by insignificant or no renewals does not fit such investment-related life products that become more valuable and management intensive as the insured ages and the policies gather more capital. The market is moving to a new model for the distribution of investment-related, no-commission, no-surrender charge products through a fiduciary of the client, where the fiduciary uses these products as a part of a holistic, multiple generation strategy. Eighty percent of life insurance buyers with investable assets of \$2 million or more report having a financial advisor, and the majority of these used their advisor for their life insurance purchase (Terry 2008).

RIAs are the new life insurance distribution system for high-end clients. RIAs have the relationship with and an understanding of their clients that makes life insurance selection and management a logical element of a comprehensive multigenerational financial planning engagement addressing legacy planning and wealth transfer. Furthermore, RIAs have the range of knowledge regarding both financial products and financial planning necessary in these types of relationships. Certified Public Accountants (CPAs), Chartered Financial Analysts (CFAs), Certified Financial Planners (CFPs), attorneys and other financial professionals may be RIAs, or employed or affiliated with RIAs. The types of job functions associated with a RIA include research analysts, portfolio managers, traders, technical and operational staff and client service professionals (Barnes, 2008).

Today's unconflicted and educated RIA is able to communicate to the wealthy client the two parts of an investment-related life insurance policy. Part one is the "amount-at-risk." The amount-at-risk is the amount of money of the total death benefit that will be life insurance company money at the insured's death. In a pure-protection life policy it is the total death benefit, but in an investment-related life insurance policy the total death benefit is comprised of the amount-at-risk and the second part which is the policyowner's capital in the policy. Everyone knows that there is a cost for the amount at risk in a pure- protection policy and that it is the cost of the contract. However, the typical consumer does not understand the charge or deduction from policy capital for the amount at risk in an investment-related policy. An advisor, working on behalf of a policyowner, will insist upon knowing the monthly amount of this cost, will want to be in control of which account it is to be deducted from, and will advise the policyowner as to the amount of capital that should be placed in the contract so that it will accomplish the policyowner's objectives. In most cases, the advisor will want a choice from a credible portfolio of accounts in order to have the required diversification and a safe haven from the creditors of the insurer's general account in case of financial difficulties at the company level.

RIAs typically earn their revenue through a management fee as a percentage of assets held for a client. The average fee is around one percent, but generally the fee drops as assets under management increase for a client. This compensation structure aligns the best interests of the client with those of the RIA and is easy to adapt to investment-related life insurance.

The number of RIAs with \$25 million or more in assets under management stood at 10,446 in 2007, up 38 percent in just five years; total assets under management totaled \$37.7 trillion in 2007 (National Regulatory Services, and Investment Adviser Association 2007). As of year-end 2007, 59 percent of RIAs provide insurance planning services to their clients, including life, health and disability (Cerulli Associates 2008). This evolution in the insurance market has precedent in the investment world where the emergence of high quality, no-load mutual funds gave impetus to the growth of the fee-only RIA distribution model where RIAs manage and monitor client investments.

THRIVING, NOT SURVIVING

As with other industries, life insurers that adapt their product structure and distribution practices to meet evolving market demands will thrive and those that do not will be challenged to survive. No-commission, no-surrender charge life insurance products fit a marketplace where one customer segment "does it themselves" via direct channels such as the internet, and the other segment outsources their life insurance decisions and management, along with their other family financial planning, to a fee-only RIA.

In addition to product offering, customer service will be a key determinant of success in competing for both types of life insurance consumers. Research indicates that underinsured individuals do not trust the distribution model built around the traditional life insurance agent. They are, however, increasingly comfortable researching basic term policies on the internet and then buying on-line or through an insurance company, non-commission compensated, in-house agent.

The successful life insurance company also must effectively service the RIA in this environment by providing the required product lineup accompanied by real-time information and product control, as well as all required in-house services and competency-compensated agent services. Fiduciaries and RIAs will demand the following:

- Insurers with quality contracts and capacity.
- Insurers with financial strength as demonstrated by high ratings from the ratings agencies and a sound fixed account.
- Credible and transparent funding costs—no commissions and no front-end loads or back-end surrender charges, state-specific premium taxes, low mortality and expense (M&E) charges (either decreasing as assets increase, or a fixed dollar M&E per policy paired with an always low percentage M&E that is less than 0.5 percent), no deferred acquisition cost (DAC) taxes since they are not premium-related.
- Credible and transparent cost of amount-at-risk, called cost of insurance (COI), with choice of monthly rates for annual renewable, 10-year level or 20-year level term. Amount-at-risk costs identical for all policy forms.
- Quality and timely underwriting.
- Policy management capabilities such as investment discretion block transfers, portfolio management system integration, and real-time transaction reporting (including last COI deduction, unit values, cash balances, and web access to key policy details.)
- Comprehensive performance reporting from the RIA, including fees and costs in a format consistent with the client's other investment assets managed.

CONCLUDING THOUGHTS

The current creative destruction of the life insurance distribution system should improve the scope and adequacy of life insurance coverage across U.S. households. The fact that this new no-commission distribution system provides the consumer with choice is likely to lead to lower commissions and the disclosure of commissions which will mean fewer excesses and better relationships with regulators.

These market developments also mean an industry more nimble in its ability to assist individuals in responding to inevitable changes in the realm of public policy and taxation. For example, the Social Security trust fund will be exhausted by 2041; at that point, payroll taxes and other income would be sufficient to pay only 78 percent of program costs. Medicare's Hospital Insurance (HI) Trust Fund will spend more than its income in 2008, and the Federal treasury will need to transfer approximately \$342 billion to cover beneficiaries' hospital insurance costs between 2009 and 2017. Changes in benefit and tax structures for both programs are inevitable and consumers will need to adapt to the new security paradigm.

Pressures on federal and state budgets also mean that increases in income taxes, capital gains taxes and estate taxes are real possibilities. Effective wealth management does not mean tax avoidance, but it does involve effective tax management within the regulations of the tax code. Today's more sophisticated, fiduciary-friendly life insurance products, delivered and managed by skilled family financial advisors, mean that those impacted by such changes will be able to adjust strategies accordingly.

REFERENCES

- Anderson, James C. H., "A Critique of Traditional Life Insurance Products and Distribution Systems," Presented to the Southeastern Actuaries Club in New Orleans, Louisiana, November 18, 1976, in *The Papers of James C. H. Anderson*, The Actuarial Education and Research Fund, Schaumburg, Illinois (1997), pp 47-55.
- American Council of Life Insurers. *Life Insurers Fact Book 2007*. ACLI (2007).
- Life Insurers Fact Book 2000*. ACLI (2000).
- Life Insurers Fact Book 1998*. ACLI (1998).
- Art, Mary M. "Optimizing Opportunities with Online Consumers: Consumer Internet Use for Insurance Information and Purchase." LIMRA International (2007a).
- "Reaching Out to the Middle Market Online." LIMRA International (2007b).
- Art, Mary M., and Nilufer Ahmed. "Building Connections: Reaching Out to Gen X and Y Online." LIMRA International (2008).
- Barnes, Ryan. "What Is A Registered Investment Advisor?" *Investopedia*. (<http://www.investopedia.com/articles/financialcareers/06/whatisaRIA.asp>). Accessed on July 29, 2008.
- Bisker, James, Paul McDaid, Lisa Schmidt, Adrian Toma and Fred Winegust. "Transforming the Insurance Carrier Into an Integrated Multichannel Sales and Service Organization Utilizing Converged Communication Technologies." IBM Consulting Services (2005).
- Cerulli Associates. *2008 Cerulli Quantitative Update: Advisor Metrics*. Cerulli (2008).
- LIMRA International. "LIMRA's Census of U.S. Sales Personnel (slide deck). (August 2007).
- National Regulatory Services, and Investment Adviser Association. "Evolution, Revolution: A Profile of the Investment Advisor Profession" (2007).
- Panko, Ron. "Motivating the Middle Market" in *Best's Review* (March 2008).
- Retzloff, Cheryl D. "Trends in Life Insurance Ownership among U.S. Households." LIMRA International (2005).
- Retzloff, Cheryl D., Ron Neyer and Patrick T. Leary. "The Direct Route to Life Insurance: Using Direct Response Channels to Purchase Life Insurance." LIMRA International (2006).
- Terry, Karen. "Why and How People Buy High Face Life." LIMRA International (2008).
- Terry, Karen. "Finding New Customers: Who is Buying Individual Life and Why?" LIMRA International (2005).
- Woods, David F. "Is Wall Street Killing Life Insurance?" in *Financial Advisor Publications* (June 2008), pp 21-23.

ABOUT THE AUTHORS

Ben G. Baldwin, Jr., MSFS, MSM, CLU, ChFC, CFP®, AEP is president and owner of Baldwin Financial Systems, LLC., Arlington Heights, Il., a registered investment advisory firm specializing in financial education and consulting for corporate and individual clients. A retired representative of AXA Advisors, LLC and AXA Equitable, he is the author of numerous articles on financial planning, and has conducted scores of educational sessions for broker/dealer groups and industry associations. Ben is the author of *The Complete Book of Insurance* (Irwin Professional Publishing 1996), *The New Life Insurance Investment Advisor* (Probus 1988, McGraw-Hill 1994; Second Edition 2002), and *The Lawyer's Guide to Insurance* (American Bar Association, Senior Lawyers Division 1999).

A graduate of the University of Rochester, he earned a MSFS and a MSM degree from The American College in Bryn Mawr, Pa. In addition, he is a Chartered Life Underwriter, Chartered Financial Consultant and a Certified Financial Planner.

Tom Holt is a Vice President with TIAA-CREF Life Insurance Company where he provides financial intermediaries, such as Registered Investment Advisors, Estate Planning Advisors, CPAs, and Financial Consultants, with innovative financial protection strategies for high net worth clients. Holt has over 30 years of experience in the financial services industry. Before joining TIAA-CREF, he served as Vice President of Advisor Services at Fidelity Investments. At ING and Jefferson Pilot, he worked with advisors on individual case consultation and educational seminars. At Sunset Financial Services, he created training curricula on variable life and annuity strategies. At Provident Mutual Life, he implemented variable insurance tactics for independent FINRA registered representatives specializing in business owners and wealthy families. Holt is a founding board member of the Financial Services Marketing Association, a former Board Member and Program Chairman of the Boston Chapter of NAIFA, a member of the Society of Financial Services Professionals, and a member of the Financial Planning Association.

Paul Yakoboski is a Principal Research Fellow with the TIAA-CREF Institute. He conducts and manages research on issues related to retirement income security, including saving and planning for retirement, retirement plan design and managing workforce retirement patterns, and research on issues related to strategic management in higher education. Prior to joining the Institute he held positions as Director of Research for the American Council of Life Insurers, Senior Research Associate with the Employee Benefit Research Institute and Senior Economist with the U.S. General Accounting Office. He is a member of the American Economic Association and serves on the editorial advisory board of *Benefits Quarterly*. He previously served as Director of Research for the American Savings Education Council. Yakoboski earned his Ph.D. and M.A. in economics from the University of Rochester and his B.S. in economics from Virginia Tech.